DNR Capital Australian Equities High Conviction Fund

APIR code: PIM0028AU

Performance Report February 2023

Performance

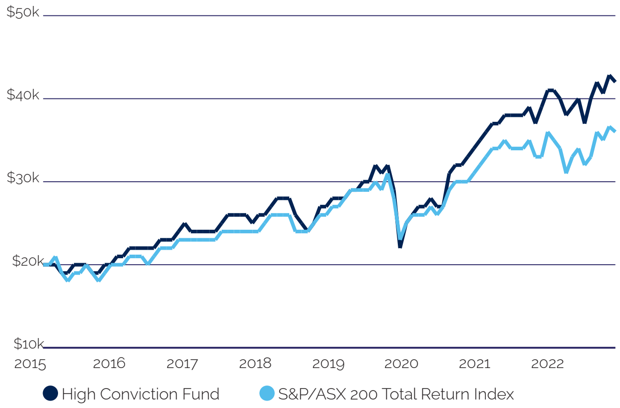
DNR Capital Australian Equities High Conviction Fund decreased 1.64% (net of fees) in February, outperforming the S&P/ASX 200 Total Return Index by 0.81%. Over the last 12 months, the Fund increased by 8.92%, outperforming the Index by 1.76% (net of fees).

Net active return as at 28 February 2023

	1mth %	3mth %	6mth %	1yr %	3yr p.a. %	5yr p.a. %	Incep.* p.a. %
High Conviction Fund	-1.64	1.44	5.86	8.92	13.44	10.09	10.14
S&P/ASX 200 Total Return Index	-2.45	0.30	6.37	7.16	7.93	7.90	7.81
Excess return	**0.81**	**1.14**	**-0.51**	**1.76**	**5.51**	**2.19**	**2.33**

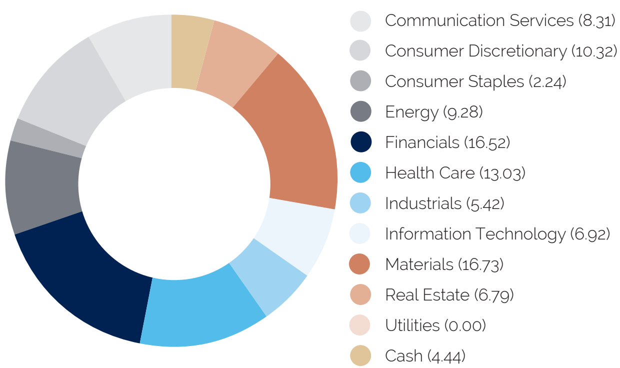
* Inception Date—June 2015.
Source: DNR Capital and Apex Fund Services.
Past performance is not an indication of future performance. Total return shown for the DNR Capital Australian Equities High Conviction Fund has been calculated using exit prices after taking into account all of the product's ongoing fees and assuming reinvestment of distributions. No allowance has been made for entry/exit fees or taxation.

Growth of $20,000 since inception



Source: DNR Capital and Apex Fund Services

Sector weightings %



Source: DNR Capital and Apex Fund Services

Top 5 active holdings

Security details
The Lottery Corporation (TLC)
CSL (CSL)
Woodside Energy Group (WDS)
Scentre (SCG)
QBE Insurance Group (QBE)

Source: DNR Capital and Apex Fund Services

Monthly top contributors and detractors

Top 3 contributors
The Lottery Corporation (TLC)
QBE Insurance Group (QBE)
Commonwealth Bank of Australia (CBA, no holding)

Top 3 detractors
Domino's Pizza Enterprises (DMP)
Lendlease (LLC)
Rio Tinto (RIO)

Source: DNR Capital and Apex Fund Services

Experienced portfolio managers

Jamie Nicol
Chief Investment Officer

Scott Bender
Portfolio Manager

Performance attribution

Contributors

- **The Lottery Corporation (TLC):** outperformed over the month after reporting continued strong trading in the lotteries business. Volumes will fluctuate with jackpot sequences however, underlying trends should support continued solid growth.
- **QBE Insurance Group (QBE):** delivered a result 20% above expectations with strong price growth and improving claims performance. With the stock cheap going into the result, it has performed well.
- **Commonwealth Bank of Australia (CBA, no holding):** delivered a strong result but was in line with expectations and highlighted that interest margins have peaked with competition for mortgages and deposits increasing.

Detractors

- **Domino's Pizza Enterprises (DMP):** underperformed following a surprisingly weak earnings result, with efforts to offset inflation failing to gain traction across the network, despite earlier suggestions these efforts were working. Following raised prices and delivery surcharges, volumes rapidly declined, impacting store profitability and rollout progress. Whilst we have reduced our exposure, the result raises questions on the business model, requiring further research.
- **Lendlease (LLC):** underperformed during the month as the outlook for higher rates weighed on the property sector in general. Management continues to make incremental progress towards the stated 2024 return targets with a sharpened focus on executing the existing development backlog of over $100bn.
- **Rio Tinto (RIO):** underperformed for the month despite the iron ore market consolidate on gains made in January. The company reported higher costs continued to weigh on profitability and provided initial production guidance for CY23, which was slightly below expectations.

Fund and market review

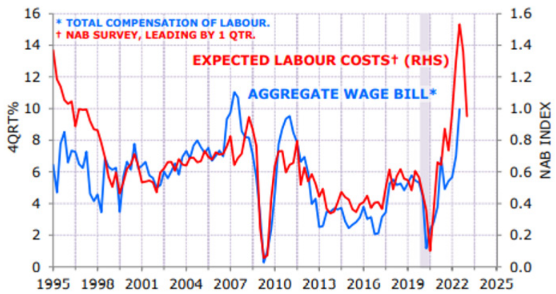
The S&P/ASX 200 Total Return Index was down 2.45% during the period. Utilities (+2.3%) was the best performing sector, following an improved takeover offer presented to Origin Energy (ORG +9.4%), allaying fears that the deal would fall through. Information Technology also outperformed (+2.2%), with key constituents Computershare (CPU +5.7%) and WiseTech Global (WTC +4.1%) benefitting from higher cash rates and reporting a key customer contract, respectively. Materials (-6.9%) was the worst performing sector, with the majors (BHP Group, BHP -8.5%, Fortescue Metals Group, FMG -0.4%, Rio Tinto, RIO -7.8%) reporting strong cost inflation and a muted demand impulse from a reopening China.

Financials (-3.8%) also underperformed, with the banks reporting a weaker outlook for loan growth as well as increasing signs of stress in their loan books. This month the market was weaker, following a strong bounce in January. Globally, the key issue for the market remains inflation and its impact on interest rates. Reporting season has concluded with mixed results which we will examine in more detail.

Inflation and interest rate trends

The domestic earnings reporting season once again highlighted tightness in the labour market. Many companies we engaged with reiterated the difficulties in securing labour. Unsurprisingly, expectations around labour costs remain elevated, maintaining upward pressure on inflation.

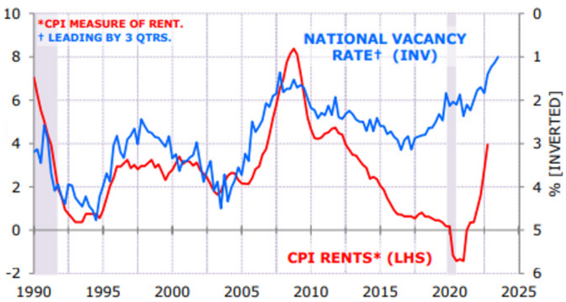
Aggregate labour pay and expected labour costs



Source: ABS, NAB, NBER; Minack Advisors

Australia will now potentially see demand boosted by the return of Chinese students and tourists. Where Australia is planning on housing the new arrivals is unclear. With the rental market already very tight, this will likely contribute to inflation in the short term.

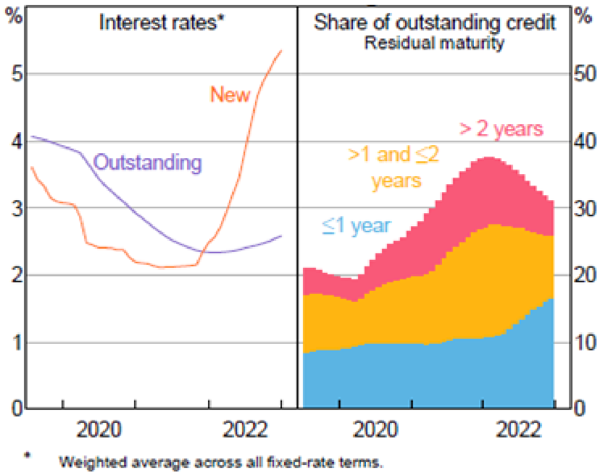
National vacancy rate and CPI rents



Source: ABS, REIV, SQM, Melbourne Institute; Minack Advisors

With wages and rents on the rise, pressure will build on the Reserve Bank of Australia (RBA) to continue lifting interest rates, further turning the screws on mortgage holders. The high proportion of fixed rate mortgages has afforded households some protection, but these will roll off over the coming year.

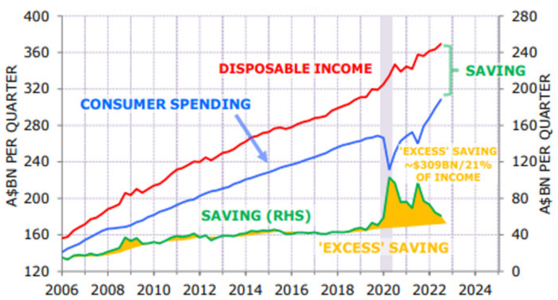
Fixed-rate housing loans



Source: APRA; RBA

The consumer has held up well to date, despite the higher interest rates. Whilst in part due to fixed mortgages, high levels of savings were also accrued during COVID-19. The outlook appears more precarious however, as house prices fall, confidence weakens and goods inflation and rising mortgage payments eat into disposable incomes.

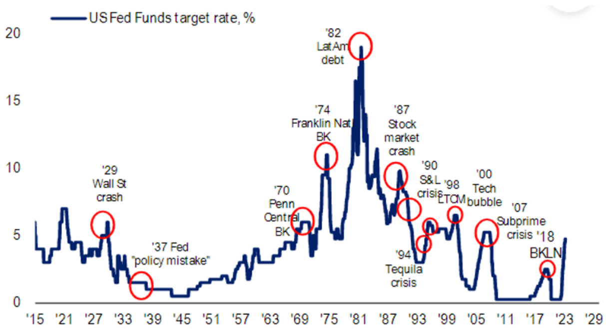
Household sector income, spending and saving



Source: ABS, NBER; Minack Advisors

When interest rates rise aggressively, something usually breaks, as noted on the following chart.

US Fed Funds Rate and significant market events

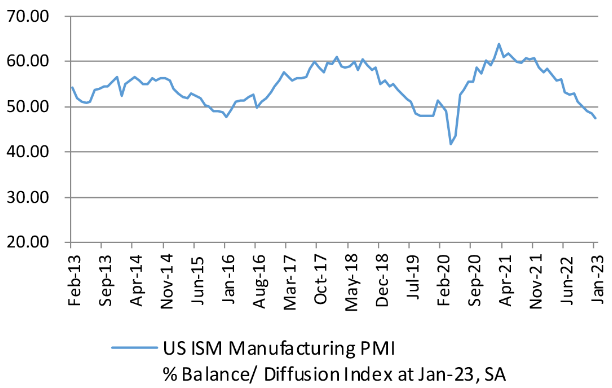


Source: BAML

The US Federal Reserve's (Fed) preferred inflation gauge, Core PCE, rose last month at its fastest pace since June, which could lead the Fed to keep raising interest rates well into this year. Consumer prices rose 0.6% from December to January, up sharply from a 0.2% increase from November to December.

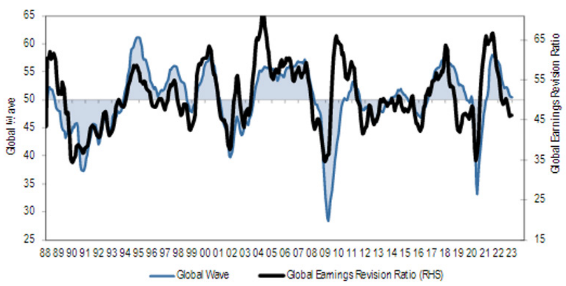
The following charts show that business confidence has fallen, and as a result, earnings are being revised down.

US Business Confidence (PMI)



Source: FactSet

BAML global wave economic indicator

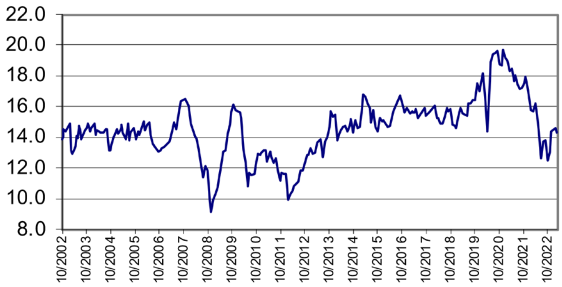


Source: BofA Global Quantitative Strategy, MSCI, IBES, Haver, Bloomberg, OECD. IMF, ICE Bond Indices, National Statistics Database

Strong household savings and full employment may see the economy hold up for longer than expected. Our concern is that the longer it holds up, the harder central banks need to tighten, and the harder the landing will be. We remain broadly cautious but recognise that softer markets present opportunities as good businesses are de-rated. As a result, we have been actively adding to a range of positions.

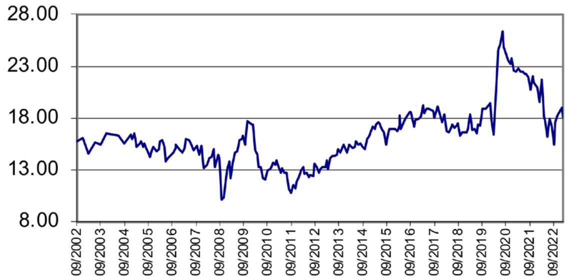
Valuations look relatively supportive in Australia, but we note the influence of the contribution from the resources sector (given reasonably positive commodity prices). As indicated below, the US market still looks modestly elevated relative to its history, particularly given current bond yields have pushed back to higher levels (providing investors an alternative).

Australian market PE



Source: FactSet

US market PE



Source: FactSet

Reporting season

Key observations:

1. Labour constraints remain topical. Many companies are struggling to find labour and are seeing labour cost increases. The increase has caused problems for a range of companies, including resource companies, industrials like Cleanaway Waste Management (CWY) and consumer stocks such as Domino's Pizza Enterprises (DMP).
2. Housing activity is slowing. Not surprisingly, higher interest rates have caused housing activity to slow for a range of builders and developers.
3. Bank margins are peaking. Banks have enjoyed a very good year for profitability with bad debts very low, customer savings high and rapidly rising interest rates yielding more on customer deposits than normal. We saw evidence of customers switching transactional deposits to higher interest paying accounts and greater competition in mortgages, suggesting a tighter margin environment later in the year.
4. Consumer stocks displayed mixed trends. Consumer staples were generally solid, and discretionary companies such as Super Retail Group (SUL) and Wesfarmers (WES) performed well. Others, like Breville Group (BRG) noted a cautious consumer.
5. Higher interest costs for companies with large debt balances presented new challenges.
6. The continued COVID-19 recovery benefitted several sectors including Health Care, while service orientated companies such as Endeavour Group (EDV) and Qantas Airways (QAN) also performed well.
7. Quality business models stood out in terms of the ability to pass on inflation and lift prices – CSL (CSL), SEEK (SEK), and Carsales.Com (CAR).
8. Insurance companies enjoyed strong results as prices lifted to offset higher catastrophes.
9. Mining services businesses achieved good results as activity levels improved.

Best results

QBE Insurance (QBE) – recorded a solid result as management's efforts to improve consistency paid off. Higher premium growth combined with higher investment returns (from higher interest rates) delivered strong outcomes for the period.

Qube Holdings (QUB) – also delivered a strong result with above market expectations and an improved outlook. Operationally, it was successful in passing on prices, continuing to benefit from elevated demand and tight supply conditions in logistics.

Worst result

Domino's Pizza Enterprises (DMP) – earnings result disappointed with efforts to pass on inflation failing across the network. Delivery surcharges and poor execution resulted in customers trading down and volumes declining. The company is now revisiting its pricing strategy to reinvigorate customer demand. The market now questions its ability to execute successfully in a tighter inflationary environment.

Fund facts

Inception date: June 2015

Minimum initial investment: $20,000

Risk level: High

Management fee: 0.90% (inclusive GST and RITC)

Performance fee: Nil

Entry/exit fees: Nil

Buy/sell spread: +0.20%/-0.20%

Valuation and unit pricing frequency: Each business day

Distribution frequency: Semi-Annual

Responsible Entity: The Trust Company (RE Services) Limited as part of the Perpetual Limited group of companies.

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About DNR Capital and the Fund

Concentrated: Investing in 15-30 highest conviction, quality large cap Australian listed equities.

Style neutral and quality focussed: A disciplined approach to quality and valuation. Concentrated portfolios of quality companies maximise the opportunity for outperformance.

Experienced and aligned team: The portfolio managers have more than 50 years of combined investment experience and are invested alongside our clients.

Proven process: DNR Capital was established in 2001 and a consistent firm-wide investment process has delivered more than 19 years of investment outperformance.

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